

BIO KEY INTERNATIONAL INC

Form 10-Q

August 14, 2015

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

**QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended June 30, 2015**

or

**TRANSITION REPORT UNDER SECTION 13 OR 15(D) OF THE EXCHANGE ACT**

**For the Transition Period from            to**

**Commission file number 1-13463**

**BIO-KEY INTERNATIONAL, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**DELAWARE**

**41-1741861**

(State or Other Jurisdiction of (IRS Employer

Incorporation of Organization) Identification Number)

**3349 HIGHWAY 138, BUILDING A, SUITE E, WALL, NJ 07719**

(Address of Principal Executive Offices)

**(732) 359-1100**

(Issuer's Telephone Number)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller Reporting Company

Indicate by check mark whether the registrant is a shell company (as defined by rule 12b-2 of the Exchange Act) Yes No

Number of shares of Common Stock, \$.0001 par value per share, outstanding as of August 13, 2015 is 66,001,260.

**BIO-KEY INTERNATIONAL, INC.**

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**PART I -- FINANCIAL INFORMATION****BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | <b>June 30,<br/>2015<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2014</b> |
|---|--|----------------------------------|
| <b>ASSETS</b>   |  |                                  |
| Cash and cash equivalents   | \$282,376                                | \$843,632                        |
| Accounts receivable, net of allowance for doubtful accounts of \$20,526 at June 30, 2015 and December 31, 2014                                | 133,985                                  | 625,341                          |
| Due from factor   | 1,542,184                                | 76,657                           |
| Inventory   | 412,569                                  | 11,825                           |
| Prepaid expenses and other  | 74,220                                   | 236,429                          |
| Total current assets  | 2,445,334                                | 1,793,884                        |
| Equipment and leasehold improvements, net   | 84,317                                   | 103,509                          |
| Deposits and other assets   | 8,712                                    | 8,712                            |
| Intangible assets—less accumulated amortization   | 154,541                                  | 161,344                          |
| Total non-current assets  | 247,570                                  | 273,565                          |
| <b>TOTAL ASSETS</b>   | <b>\$2,692,904</b>                       | <b>\$2,067,449</b>               |
| <b>LIABILITIES</b>  |  |                                  |
| Accounts payable  | \$869,114                                | \$347,311                        |
| Accrued liabilities   | 436,293                                  | 488,617                          |
| Deferred revenue  | 601,751                                  | 429,233                          |
| Warrant liabilities   | 28,974                                   | 43,227                           |
| Total current liabilities   | 1,936,132                                | 1,308,388                        |
| <b>TOTAL LIABILITIES</b>  | <b>1,936,132</b>                         | <b>1,308,388</b>                 |
| Commitments and contingencies   |  |                                  |
| <b>STOCKHOLDERS' EQUITY</b>   |  |                                  |
| Common stock — authorized, 170,000,000 shares; issued and outstanding; 66,001,260 of \$.0001 par value at June 30, 2015 and December 31, 2014 | 6,600                                    | 6,600                            |
| Additional paid-in capital  | 57,675,273                               | 57,506,605                       |
| Accumulated deficit   | (56,925,101)                             | (56,754,144)                     |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>   | <b>756,772</b>                           | <b>759,061</b>                   |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>   | <b>\$2,692,904</b>                       | <b>\$2,067,449</b>               |

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.

**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(Unaudited)**

|  | <b>Three months ended</b> |                | <b>Six months ended</b>  |                |
|--|---------------------------|----------------|--------------------------|----------------|
|  | <b>June 30,<br/>2015</b>  | <b>2014</b>    | <b>June 30,<br/>2015</b> | <b>2014</b>    |
| Revenues   |                           |                |                          |                |
| Services   | \$255,269                 | \$281,711      | \$505,622                | \$530,942      |
| License fees and other                             | 2,017,535                 | 121,078        | 2,416,008                | 1,239,369      |
|  | 2,272,804                 | 402,789        | 2,921,630                | 1,770,311      |
| Costs and other expenses                           |                           |                |                          |                |
| Cost of services                                   | 56,905                    | 113,105        | 123,968                  | 152,280        |
| Cost of license fees and other                     | 88,489                    | 48,146         | 160,782                  | 126,195        |
|  | 145,394                   | 161,251        | 284,750                  | 278,475        |
| Gross Profit                                       | 2,127,410                 | 241,538        | 2,636,880                | 1,491,836      |
| Operating Expenses                                 |                           |                |                          |                |
| Selling, general and administrative                | 979,861                   | 895,147        | 2,020,542                | 1,752,143      |
| Research, development and engineering              | 393,999                   | 470,888        | 800,640                  | 957,545        |
|  | 1,373,860                 | 1,366,035      | 2,821,182                | 2,709,688      |
| Operating profit (loss)                            | 753,550                   | (1,124,497 )   | (184,302 )               | (1,217,852 )   |
| Other income (expenses)                            |                           |                |                          |                |
| Interest income                                    | 2                         | 2              | 4                        | 3              |
| Gain (loss) on derivative liabilities              | (406 )                    | 98,209         | 14,253                   | (106,739 )     |
| Income taxes                                       | -                         | -              | (912 )                   | (912 )         |
| Total other income (expenses)                      | (404 )                    | 98,211         | 13,345                   | (107,648 )     |
| Net profit (loss)                                  | \$753,146                 | \$(1,026,286 ) | \$(170,957 )             | \$(1,325,500 ) |
| Basic and Diluted Earnings (Loss) per Common Share | \$0.01                    | \$(0.02 )      | \$(0.00 )                | \$(0.02 )      |
| <b>Weighted Average Shares Outstanding:</b>        |                           |                |                          |                |
| Basic and diluted                                  | 66,001,260                | 58,001,934     | 66,001,260               | 57,970,309     |

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.

**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(Unaudited)**

|  | <b>Six Months Ended June</b> |                    |
|--|------------------------------|--------------------|
|  | <b>30,</b>                   |                    |
|  | <b>2015</b>                  | <b>2014</b>        |
| <b>CASH FLOW FROM OPERATING ACTIVITIES:</b>                                    |                              |                    |
| Net loss   | \$(170,957 )                 | \$(1,325,500)      |
| <b>Adjustments to reconcile net loss to cash used in operating activities:</b> |                              |                    |
| Depreciation   | 21,270                       | 20,016             |
| Amortization   |                              |                    |
| Intangible assets  | 6,803                        | 6,803              |
| Loss (gain) on derivative liabilities  | (14,253 )                    | 106,739            |
| Share-based and warrant compensation   | 222,247                      | 132,218            |
| Exercise of stock options  | -                            | 14,651             |
| <b>Change in assets and liabilities:</b>                                       |                              |                    |
| Accounts receivable trade  | 491,356                      | (100,794 )         |
| Due from factor, net   | (1,465,527)                  | (18,678 )          |
| Inventory  | (400,744 )                   | (12,873 )          |
| Prepaid expenses and other   | 162,209                      | (709 )             |
| Accounts payable   | 521,803                      | (188,850 )         |
| Accrued liabilities  | (52,324 )                    | 39,324             |
| Deferred revenue   | 172,518                      | (22,436 )          |
| Net cash used for operating activities   | (505,599 )                   | (1,350,089)        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                   |                              |                    |
| Capital expenditures   | (2,078 )                     | (5,501 )           |
| Net cash used for investing activities   | (2,078 )                     | (5,501 )           |
| <b>CASH FLOW FROM FINANCING ACTIVITIES:</b>                                    |                              |                    |
| Repurchase of outstanding warrants   | -                            | (150,000 )         |
| Costs to issue common stock  | (53,579 )                    | -                  |
| Net cash used for financing activities   | (53,579 )                    | (150,000 )         |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                               | <b>(561,256 )</b>            | <b>(1,505,590)</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                          | <b>843,632</b>               | <b>2,023,349</b>   |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                                | <b>\$282,376</b>             | <b>\$517,759</b>   |

The accompanying notes to the condensed consolidated financial statements are an integral part of these statements.





**BIO-KEY INTERNATIONAL, INC. AND SUBSIDIARY**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

June 30, 2015 (Unaudited)

**1. NATURE OF BUSINESS AND BASIS OF PRESENTATION**

*Nature of Business*

BIO-key International, Inc. was founded in 1993 as a fingerprint biometric technology company. Biometric technology is the science of analyzing specific human characteristics which are unique to each individual in order to identify a specific person from a broader population. We develop and market advanced fingerprint biometric identification and identity verification technologies, cryptographic authentication-transaction security technologies, as well as related identity management and credentialing software solutions. We sell our products and provide services primarily to commercial entities within highly regulated industries, like healthcare and financial services and the broader corporate enterprise.

*Basis of Presentation*

The accompanying unaudited interim condensed consolidated financial statements include the accounts of BIO-key International, Inc. and its wholly-owned subsidiary (collectively, the "Company") and are stated in conformity with accounting principles generally accepted in the United States of America ("GAAP"), pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). The operating results for interim periods are not necessarily indicative of results that may be expected for any other interim period or for the full year. Pursuant to such rules and regulations, certain financial information and footnote disclosures normally included in the financial statements have been condensed or omitted. Significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying unaudited interim consolidated financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company's financial position and the results of its operations and cash flows for the periods presented. The balance sheet at December 31, 2014 was derived from the audited financial statements, but does not include all of the disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2014 (the "Form 10- K"), filed with the SEC on March 31, 2015.

*Recently Issued Accounting Pronouncements*

In January 2015, ASU No. 2015-01, "Income Statement – Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary items" ("ASU 2015-01") was issued. ASU 2015-01 eliminates from GAAP the concept of extraordinary items. ASU 2015-01 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively. A reporting entity also may apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company is currently evaluating the effects of adopting ASU 2014-15 on its consolidated financial statements but the adoption is not expected to have a significant impact.

In April 2015, the FASB issued ASU 2015-03, "Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs." ASU 2015-03 requires debt issuance costs related to a debt liability measured at amortized cost to be reported in the balance sheet as a direct deduction from the face amount of the debt liability. ASU 2015-03 is effective for interim and annual periods beginning January 1, 2016 with early adoption permitted, and is applied on a retrospective basis. The adoption of ASU 2015-03 is not expected to materially impact the Company's consolidated financial statements.

In July 2015 the FASB issued ASU No. 2015-11, "Inventory (Topic 330): Simplifying the Measurement of Inventory" ("ASU 2015-11"). The amendments in ASU 2015-11 clarifies the measurement of inventory to be the lower of cost or realizable value and would only apply to inventory valued using the FIFO or average costing methods. ASU 2015-11 is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. The reporting entity should apply the amendments prospectively with earlier application permitted as of the beginning as of the beginning of an interim or annual reporting period. The Company is currently evaluating the effects of adopting ASU 2015-11 on its consolidated financial statements.

Management does not believe that any other recently issued, but not yet effective, accounting standard if currently adopted would have a material effect on the accompanying consolidated financial statements.

## 2. GOING CONCERN

The Company has incurred significant losses to date and at June 30, 2015, had an accumulated deficit of approximately \$57 million. In addition, broad commercial acceptance of the Company's technology is critical to the Company's success and ability to generate future revenues. At June 30, 2015, the Company's total cash and cash equivalents were approximately \$282,000, as compared to approximately \$844,000 at December 31, 2014.

The Company has financed itself in the past through access to the capital markets by issuing secured and convertible debt securities, convertible preferred stock, common stock, and through factoring receivables. The Company estimates that it currently requires approximately \$460,000 per month to conduct operations, a monthly amount that it has been unable to achieve consistently through revenue generation.

If the Company is unable to generate sufficient revenue to meet its goals, it will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute its plan to substantially grow operations, increase revenue, and serve a significant customer base; and (ii) provide working capital. No assurance can be given that any form of additional financing will be available on terms acceptable to the Company, that adequate financing will be obtained by the Company, in order to meet its needs, or that such financing would not be dilutive to existing shareholders.

The accompanying financial statements have been prepared in conformity with GAAP, which contemplate continuation of the Company as a going concern, and assumes continuity of operations, realization of assets and the satisfaction of liabilities and commitments in the normal course of business. The matters described in the preceding paragraphs raise substantial doubt about the Company's ability to continue as a going concern. Recoverability of a major portion of the recorded asset amounts shown in the accompanying balance sheet is dependent upon the Company's ability to meet its financing requirements on a continuing basis, and become profitable in its future operations. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amounts and classification of liabilities that might be necessary should the Company be unable to continue in existence.

### 3. SHARE BASED COMPENSATION

The following table presents share-based compensation expenses included in the Company's unaudited condensed interim consolidated statements of operations:

|                                       | <b>Three Months ended</b> | <b>Three Months ended</b> |
|---------------------------------------|---------------------------|---------------------------|
|                                       | <b>June 30,</b>           | <b>June 30,</b>           |
|                                       | <b>2015</b>               | <b>2014</b>               |
| Selling, general and administrative   | \$ 28,760                 | \$ 18,985                 |
| Research, development and engineering | 5,611                     | 27,460                    |
|                                       | <b>\$ 34,371</b>          | <b>\$ 46,445</b>          |
|                                       | <b>Six</b>                | <b>Six</b>                |
|                                       | <b>Months</b>             | <b>Months</b>             |
|                                       | <b>ended</b>              | <b>ended</b>              |

|                                       | <b>June 30,<br/>2015</b> | <b>June 30,<br/>2014</b> |
|---------------------------------------|--------------------------|--------------------------|
| Selling, general and administrative   | \$162,218                | \$93,826                 |
| Research, development and engineering | 34,372                   | 38,392                   |
|                                       | <b>\$196,590</b>         | <b>\$132,218</b>         |

#### 4. FACTORING

Due from factor consisted of the following as of:

|                        | <b>June 30,<br/>2015</b> | <b>December<br/>31,<br/>2014</b> |
|------------------------|--------------------------|----------------------------------|
| Original invoice value | \$2,184,290              | \$306,625                        |
| Factored amount        | (315,739 )               | (229,968 )                       |
| Due to factor          | (326,367 )               | -                                |
| Due from factor        | <b>\$1,542,184</b>       | <b>\$76,657</b>                  |

As of December 2011, the Company entered into a 24 month accounts receivable factoring arrangement with a financial institution (the “Factor”). Pursuant to the terms of the arrangement, the Company, from time to time, sells to the Factor certain of its accounts receivable balances on a non-recourse basis for credit approved accounts. The Factor remits 35% for foreign and 75% for domestic of the accounts receivable balance to the Company (the “Advance Amount”), with the remaining balance, less fees to be forwarded to the Company once the Factor collects the full accounts receivable balance from the customer. Factoring fees range from 2.75% to 21% of the face value of the invoice factored, and are determined by the number of days required for collection of the invoice. In April 2012, the terms were updated from monthly to quarterly, and the 24-month arrangement was extended to August 1, 2014. In July of 2014, the arrangement was extended to July 31, 2016.

## 5. INVENTORY

Inventory is stated at the lower of cost, determined on a first in, first out basis, or market, and consists primarily of fabricated assemblies and finished goods. Inventory is comprised of the following as of:

|                       | <b>June 30,<br/>2015</b> | <b>December<br/>31,<br/>2014</b> |
|-----------------------|--------------------------|----------------------------------|
| Finished goods        | \$40,588                 | \$ 11,825                        |
| Fabricated assemblies | 371,981                  | -                                |
| Total inventory       | \$412,569                | \$ 11,825                        |

## 6. EARNINGS (LOSS) PER SHARE COMMON STOCK (“EPS”)

The Company’s basic EPS is calculated using net income (loss) available to common stockholders and the weighted-average number of shares outstanding during the reporting period. Diluted EPS includes the effect from potential issuance of common stock, such as stock issuable pursuant to the exercise of stock options and warrants and the assumed conversion of convertible notes and preferred stock.

The reconciliation of the numerators of the basic and diluted EPS calculations was as follows for both of the following three and six month periods ended June 30:

|  | <b>Three Months ended<br/>June 30,</b> |               | <b>Six Months ended June<br/>30,</b> |               |
|--|--|---------------|--------------------------------------|---------------|
|  | <b>2015</b>                            | <b>2014</b>   | <b>2015</b>                          | <b>2014</b>   |
| <b>Basic Numerator:</b>                            |  |               |                                      |               |
| Net income (loss) available to common stockholders | \$753,146                              | \$(1,026,286) | \$(170,957)                          | \$(1,325,500) |
| Basic Denominator                                  | 66,001,260                             | 58,001,934    | 66,001,260                           | 57,970,309    |
| Per Share Amount                                   | 0.01                                   | (0.02)        | (0.00)                               | (0.02)        |

The following table sets forth the options and warrants which were excluded from the diluted per share calculation even though the exercise prices were less than the average market price of the common shares because the effect of including these potential shares was antidilutive for the three and six months ended June 30:

|               | <b>Three<br/>Months<br/>ended<br/><br/>June 30,<br/>2015</b> | <b>Six Months ended<br/><br/>June 30,<br/>2015    2014</b> |           |
|---------------|--|--|-----------|
| Stock options | - 1,469,162  | 34,349   | 1,034,736 |
| Warrants      | - 771,123  | -  | -         |
| Total         | - 2,240,285  | 34,349   | 1,034,736 |

Items excluded from the diluted per share calculation because the exercise price was greater than the average market price of the common shares:

|               | <b>Three Months ended</b> |             | <b>Six Months ended</b> |             |
|---------------|---------------------------|-------------|-------------------------|-------------|
|               | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|               | <b>2015</b>               | <b>2014</b> | <b>2015</b>             | <b>2014</b> |
| Stock options | 3,475,000                 | 205,000     | 3,087,500               | 205,000     |
| Warrants      | 19,622,081                | 125,000     | 19,622,081              | 15,184,565  |
| Total         | 23,097,081                | 330,000     | 22,709,581              | 15,389,565  |

## 7. STOCKHOLDERS' EQUITY

### Derivative Liabilities

In connection with the issuances of equity instruments or debt, the Company may issue options or warrants to purchase common stock. In certain circumstances, these options or warrants may be classified as liabilities, rather than as equity. In addition, the equity instrument or debt may contain embedded derivative instruments, such as conversion options or listing requirements, which in certain circumstances may be required to be bifurcated from the associated host instrument and accounted for separately as a derivative liability instrument. The Company accounts for derivative liability instruments under the provisions of FASB ASC 815, "Derivatives and Hedging."

### Securities Purchase Agreements dated October 25, 2013 and November 8, 2013

Pursuant to a series of Private Investors Securities Purchase Agreements (the "PI SPA"), on October 25, 2013 and November 8, 2013, the Company issued to certain private investors an aggregate of 12,323,668 units consisting of 12,323,668 post split shares of common stock (the "Shares") and warrants to purchase an additional 12,323,668 post-split shares of common stock (the "Warrants") for an aggregate purchase price of \$3,697,100. The warrants are immediately exercisable at an exercise price of \$0.50 per post-split share, have a term of three years, and were exercisable on a cashless basis if at any time following the nine month anniversary of the issuance date, there is not an effective registration statement covering the public resale of the shares of Common Stock underlying the warrants. The Company filed a registration statement on November 22, 2013 and such registration was declared effective on December 31, 2013.



In connection with the share issuances described above, and pursuant to a placement agency letter agreement, the Company paid the placement agent cash commissions equal to 8% of the gross proceeds of the offering, reimbursed the placement agent for its reasonable out of pocket expenses, and issued to the placement agent warrants (the "Placement Agent Warrants") to purchase an aggregate of 985,893 post split shares of common stock. The Placement Agent Warrants have substantially the same terms as the warrants issued to the investors, except the Placement Agent Warrants are immediately exercisable on a cashless basis.

The cashless exercise features contained in the warrants are considered to be derivatives and the Company recorded warrant liabilities on the consolidated balance sheet. The Company initially recorded the warrant liabilities equal to their estimated fair value of \$325,891. Such amount was also recorded as a reduction of additional paid-in capital. The Company is required to mark-to-market the warrant liabilities at the end of each reporting period. For the quarter ended June 30, 2015, the Company recorded a loss on the change in fair value of the cashless exercise features of \$406. For the six months ended June 30, 2015, the Company recorded a net gain on the change in fair value of the cashless exercise feature of \$14,253. As of June 30, 2015, the fair value of the cashless exercise features was \$28,974. The fair value of the cashless exercise features was \$43,227 as of December 31, 2014.

Securities Purchase Agreement dated November 13, 2014

Pursuant to a Securities Purchase Agreement, dated November 13, 2014, by and between the Company and a number of private and institutional investors (the “November 2014 Private Investor SPA”), the Company issued to certain private investors 7,974,999 post split shares of common stock and warrants to purchase an additional 11,962,501 post split shares of common stock for aggregate gross proceeds of \$1,595,000. In addition, for each share purchased in this offering, the investors surrendered to the Company for cancellation a warrant to acquire one share of our common stock which we previously issued in a private placement transaction in November 2013. This resulted in the cancellation of warrants to purchase an aggregate of 7,974,999 post split shares of common stock.

The common stock has a purchase price reset feature. If at any time prior to the two year anniversary of the effective date of the registration statement covering the public resale of such shares, the Company sells or issues shares of common stock or securities that are convertible into common stock at a price lower than \$0.20 per share, the Company will be required to issue additional shares of common stock for no additional consideration.

Based on an evaluation as discussed in FASB ASC 815-15, “Embedded Derivatives” and FASB ASC 815-40-15, “Contracts in Entity’s Own Equity - Scope and Scope Exceptions,” the Company determined that the purchase price reset feature in the common stock issued was not considered indexed to its own stock because neither the occurrence of a sale of equity securities by the issuer at market nor the issuance of another equity contract with a lower strike price is an input to the fair value of a fixed-for-fixed option or forward on equity shares. As such, the purchase price reset feature should be bifurcated from the common stock and accounted for as a derivative liability.

The Company valued the purchase price reset feature using a Monte Carlo simulation at the date of issuance, December 31, 2014, and June 30, 2015, and determined that the purchase price reset feature had no value as the calculated price of the common stock was not below \$0.20 per share.

The warrants have a term of five years and an exercise price of \$0.30 per post-split share. Warrants to purchase 5,981,251 post-split shares of common stock were immediately exercisable. The remaining warrants to purchase 5,981,250 post-split shares of common stock became exercisable on the completion of a 1 - for - 2 reverse split of the Company's common stock in February 2015.

The warrants have customary anti-dilution protections including a “full ratchet” anti-dilution adjustment provision which are triggered in the event the Company sells or grants any additional shares of common stock, options, warrants or other securities that are convertible into common stock at a price lower than \$0.30 per share. The anti-dilution adjustment provision is not triggered by certain “exempt issuances” which among other issuances, includes the issuance of shares of common stock, options or other securities to officers, employees, directors, consultants or service

providers.

The warrants are exercisable on a cashless basis if at any time there is no effective registration statement covering the resale of the shares of common stock underlying the warrants. See below.

Based on an evaluation as discussed in FASB ASC 815-15, "Embedded Derivatives" and FASB ASC 815-40-15, "Contracts in Entity's Own Equity - Scope and Scope Exceptions," the Company determined that the full ratchet anti-dilution feature in the warrants issued were not considered indexed to its own stock because neither the occurrence of a sale of equity securities by the issuer at market nor the issuance of another equity contract with a lower strike price is an input to the fair value of a fixed-for-fixed option or forward on equity shares. As such, the full ratchet anti-dilution feature should be bifurcated from the warrants and accounted for as a derivative liability.

The Company did not value the derivative liability. One of the key determinants of the Company's decision to not value the derivative liability was the high likelihood that a future financing would not occur that would trigger the down round feature. Whether a future equity financing would occur would be determined by the cash needs of the Company and management's willingness to trigger the down round feature. The Company's reasons were as follows:

1. The Company's cash position.
2. The stock price of the Company's common stock.

Under GAAP, the Company is required to mark-to-market the derivative liability at the end of each reporting period. The Company did not value the derivative liability at the date of issuance, December 31, 2014 or June 30, 2015. At such dates, the Company determined that it was highly unlikely that an equity financing would occur. Such conclusion was based upon the discussion noted above.

The Company filed a registration statement on Form S-1 with the SEC to register the public resale of 13,956,250 of the shares of common stock issued in the November 2014 Private Investor SPA. The registration statement was declared effective on January 29, 2015. Post reverse split, the Company filed a registration statement on Form S-1 with the SEC to register the balance of the shares of common stock issued under the November 2014 Private Investor SPA which was declared effective on May 4, 2015.

### Warrants

On March 9, 2015, the Company issued a warrant to purchase 575,000 shares of common stock to an independent contractor which vests 25% every three months and is exercisable at a strike price of \$0.21 per share through March 8, 2020.

Share based expense related to the value of the stock warrants is recorded over the requisite service period, which is generally the vesting period for each tranche. Stock warrants issued by the Company are valued using the Black-Scholes option-pricing model. For the three and six months ended June 30, 2015, the Company recorded an expense of \$25,657 related to the stock warrants.

### Issuances of Stock Options

During the three and six months ended June 30, 2015, the Company granted 0 and 75,000 stock options to new employees. The options are exercisable for a term of seven years and vest in equal installments over a three-year period commencing on the date of grant. The options are exercisable at \$0.20 per share.

The fair value of the options was estimated on the date of grant at \$12,047 using the Black-Scholes option-pricing model with the following assumptions: risk free interest rate – 1.5%, expected life of options in years – 5.5, expected dividends – 0, volatility of stock price – 118%.

## 8. SEGMENT INFORMATION

The Company has determined that its continuing operations are one discrete segment consisting of biometric products. Geographically, North American sales accounted for approximately 19% and 62% of the Company's total sales for the

three months ended June 30, 2015 and 2014, respectively, and were approximately 26% and 29% of the Company's total sales for the six months ended June 30, 2015 and 2014, respectively.

## 9. FAIR VALUES OF FINANCIAL INSTRUMENTS

Cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, and notes payable, are carried at, or approximate, fair value because of their short-term nature.

The fair value of the warrant liabilities were measured using the following assumptions:

|                           |       |   |       |
|---------------------------|-------|---|-------|
| Risk-free interest rate   | 0.40% | – | 0.42% |
| Expected term             | 1.32  | – | 1.36  |
| Expected dividends        | 0     |   |       |
| Volatility of stock price | 78.5% | – | 78.9% |

The warrant liabilities are considered Level 3 liabilities on the fair value hierarchy as the determination of fair value includes various assumptions about future activities and the Company's stock prices and utilizes historical volatility as inputs.

|                               |          |
|-------------------------------|----------|
| Warrant issued under PI SPA   |          |
| Fair value at January 1, 2015 | \$43,227 |
| Gain on derivative            | (14,253) |
| Balance, June 30, 2015        | \$28,974 |

#### 10. MAJOR CUSTOMERS AND ACCOUNTS RECEIVABLE

For the three months ended June 30, 2015 and 2014, one customer accounted for 81%, and two customers accounted for 55% of revenue, respectively. For the six months ended June 30, 2015 and 2014, one customer accounted for 63%, and two customers accounted for 73% of revenue, respectively.

At June 30, 2015, four customers accounted for 52% of accounts receivable. At December 31, 2014, one customer accounted for 62% of accounts receivable.

#### 11. CONTINGENCY

On or about March 13, 2014, LifeSouth Community Blood Centers, Inc. filed a lawsuit against us the Company in the Superior Court of Monmouth County, New Jersey (MON-L-1042-14) alleging a breach of a license agreement and seeking return of all amounts paid under the license in the amount of \$718,500. The Company has denied all claims and asserted a counterclaim against LifeSouth for non-payment of support and maintenance service fees. Discovery has commenced and is proceeding. The Company has filed a motion seeking summary judgment in its favor with respect to all claims.

#### 12. SUBSEQUENT EVENTS

The Company has reviewed subsequent events through the date of filing.

## **ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS 2. OF OPERATIONS**

### **CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS**

The information contained in this Report on Form 10-Q and in other public statements by us and our officers include or may contain certain forward-looking statements. All statements other than statements of historical facts contained in this Report, including statements regarding our future financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. The words "anticipate," "believe," "estimate," "will," "may," "future," "plan," "intend" and "expect" and similar expressions generally identify forward-looking statements. These forward-looking statements are not guarantees and are subject to known and unknown risks, uncertainties and assumptions that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Although we believe that our plans, intentions and expectations reflected in the forward-looking statements are reasonable, we cannot be sure that they will be achieved. Particular uncertainties that could cause our actual results to be materially different than those expressed in our forward-looking statements include: our history of losses and limited revenue; our ability to raise additional capital; our ability to protect our intellectual property; changes in business conditions; changes in our sales strategy and product development plans; changes in the marketplace; continued services of our executive management team; security breaches; competition between us and other companies in the biometric technology industry; market acceptance of biometric products generally and our products under development; delays in the development of products and statements of assumption underlying any of the foregoing, as well as other factors set forth under the caption "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2014 filed with the Securities and Exchange Commission. All subsequent written and oral forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by the foregoing. Except as required by law, we undertake no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

### **OVERVIEW**

We develop and market advanced fingerprint biometric identification and identity verification technologies, cryptographic authentication-transaction security technologies, as well as related identity management and credentialing software solutions. We were pioneers in developing automated, finger identification technology that supplements or compliments other methods of identification and verification, such as personal inspection identification, passwords, tokens, smart cards, ID cards, PKI, credit card, passports, driver's licenses, OTP or other form of possession or knowledge-based credentialing. Advanced BIO-key® technology has been and is used to improve both the accuracy and speed of competing finger-based biometrics.

In partnerships with OEMs, integrators, and solution providers, we provide biometric software solutions to private and public sector customers. We provide the ability to positively identify and authenticate individuals before granting

access to valuable corporate resources, web portals or applications in seconds. Powered by our patented Vector Segment Technology™ or VST™, WEB-key® and BSP development kits are fingerprint biometric solutions that provide interoperability with all major reader manufacturers, enabling application developers and integrators to integrate fingerprint biometrics into their applications.

We have developed what we believe is the most discriminating and effective commercially available finger-based biometric technology. Our primary focus is in marketing and selling this technology into commercial logical and physical privilege entitlement & access control markets. Our primary market focus includes, among others, mobile payments & credentialing, online payments and credentialing, and healthcare record and payment data security. Our secondary focus includes government markets, primarily law enforcement forensic investigation and Department of Homeland Security.



## STRATEGIC OUTLOOK

Historically, our largest market has been access control within highly regulated industries such as healthcare. However, we believe the mass adoption of advanced smart-phone and hand-held wireless devices has caused commercial demand for advanced user authentication to emerge. The introduction of smart-phone capabilities, like mobile payments and credentialing, could effectively require biometric user authentication on mobile devices to reduce risks of identity theft, payment fraud and other forms of fraud in the mobile or cellular-based world wide web. As more services and payment functionalities, such as mobile wallets and near field communication (NFC), migrate to smart-phones, the value and potential risk associated with such systems should grow and drive demand and adoption of advanced user authentication technologies, including fingerprint biometrics and BIO-key solutions.

In October 2013, Apple Computer Corporation released the Apple iPhone 5s smartphone (“5s”). We believe the 5s to be the first broadly distributed smartphone to incorporate fingerprint biometrics in the phone. Since that time, HTC Corporation has also released a fingerprint biometric enabled smartphone. We believe other smartphone, tablet, laptop and related smart-device manufacturers will additionally make fingerprint-enabled smart devices available for consumer applications. As devices with onboard fingerprint sensors continue to deploy to consumers, we expect that third party application developers will demand the ability to authenticate users of their respective applications with the onboard fingerprint biometric. We further believe that authentication will occur on the device itself for potentially low-value, and therefore low-risk, use-transactions and that user authentication for high-value transactions will migrate to the application provider’s authentication server, typically located within their supporting technology infrastructure, or cloud. We have developed our technology to enable on-device authentication as well as network or cloud-based authentication and believe we may be the only technology vendor capable of providing this flexibility and capability.

We believe there is potential for significant market growth in three key areas:

corporate network access control, including corporate campuses, computer networks and applications;

consumer mobile credentialing, including mobile payments, credit and payment card programs, data and application access, and commercial loyalty programs; and

government services and highly regulated industries, including Medicare, Medicaid, Social Security, drivers licenses, campus and school ID, passports/visas.

In the near-term, we expect to grow our business within government services and highly-regulated industries in which we have historically had a strong presence, such as the healthcare industry. We believe that continued heightened security and privacy requirements in these industries will generate increased demand for security solutions, including biometrics.

Over the longer term, we intend to expand our business into the cloud and mobile computing industries. The emergence of cloud computing and mobile computing are primary drivers of commercial and consumer adoption of advanced authentication applications, including biometric and BIO-key authentication capabilities. As the value of assets, services and transactions increases on such networks, we expect that security and user authentication demand should rise proportionately. Our integration partners include major web and network technology providers, who we believe will deliver our cloud-applicable solutions to interested service-providers. These service-providers could include, but are not limited to, financial institutions, web-service providers, consumer payment service providers, credit reporting services, consumer data service providers, healthcare providers and others. Additionally, our integration partners include major technology component providers and OEM manufacturers, who we believe will deliver our device-applicable solutions to interested hardware manufacturers. Such manufacturers could include cellular handset and smartphone manufacturers, tablet manufacturers, laptop and PC manufacturers, among other hardware manufacturers.

## CRITICAL ACCOUNTING POLICIES

For detailed information regarding our critical accounting policies and estimates, see our financial statements and notes thereto included in this Report and in our Annual Report on Form 10-K, for the year ended December 31, 2014. There have been no material changes to our critical accounting policies and estimates from those disclosed in our most recent Annual Report on Form 10-K.

## RECENT ACCOUNTING PRONOUNCEMENTS

For detailed information regarding recent account pronouncements, see Notes to Condensed Consolidated Financial Statements included in Part I, Item 1 of this report.

## RESULTS OF OPERATIONS

### THREE MONTHS ENDED JUNE 30, 2015 AS COMPARED TO JUNE 30, 2014

#### Consolidated Results of Operations - Percent Trend

|                                 | <b>Three<br/>Months<br/>Ended June<br/>30,<br/>2015</b> |       | <b>2014</b> |  |
|---------------------------------|---|-------|-------------|--|
| <b>Revenues</b>                 |   |       |             |  |
| Services                        | 11 %  | 70 %  |             |  |
| License fees and other          | 89 %  | 30 %  |             |  |
| Total Revenues                  | 100 %   | 100 % |             |  |
| <b>Costs and other expenses</b> |   |       |             |  |
| Cost of services                | 3 %   | 28 %  |             |  |
| Cost of license fees and other  | 4 %   | 12 %  |             |  |

|                                       |      |       |
|---------------------------------------|------|-------|
| Total Cost of Goods Sold              | 6 %  | 40 %  |
| Gross profit                          | 93 % | 60 %  |
| <b>Operating expenses</b>             |      |       |
| Selling, general and administrative   | 43 % | 222 % |
| Research, development and engineering | 17 % | 117 % |
| Total Operating Expenses              | 60 % | 339 % |
| <b>Operating (loss) income</b>        | 33 % | -279% |
| Other income (expenses)               | 0 %  | 24 %  |
| <b>Net (loss) income</b>              | 33 % | -255% |

**Revenues and cost of goods sold**

|                      | Three months ended<br>June 30, |           |             |             |   |
|----------------------|--------------------------------|-----------|-------------|-------------|---|
|                      | 2015                           | 2014      | \$ Change   | %<br>Change |   |
| <i>Revenues</i>      |                                |           |             |             |   |
| Service              | \$255,269                      | \$281,711 | \$(26,442 ) | -9          | % |
| License & other      | 2,017,535                      | 121,078   | 1,896,457   | 1566        | % |
| <i>Total Revenue</i> | \$2,272,804                    | \$402,789 | \$1,870,015 | 464         | % |

|                           | <b>Three months<br/>ended June 30,</b> |             | <b>\$ Change</b> |   | <b>% Change</b> |
|---------------------------|--|-------------|------------------|---|-----------------|
|                           | <b>2015</b>                            | <b>2014</b> |                  |   |                 |
| <i>Cost of Goods Sold</i> |  |             |                  |   |                 |
| Service                   | \$56,905                               | \$113,105   | \$(56,200)       | ) | -50 %           |
| License & other           | 88,489                                 | 48,146      | 40,343           |   | 84 %            |
| <i>Total COGS</i>         | \$145,394                              | \$161,251   | \$(15,857)       | ) | -10 %           |

### *Revenues*

For the three months ended June 30, 2015 and 2014, service revenues included approximately \$145,000 and \$141,000, respectively, of recurring maintenance and support revenue, and approximately \$110,000 and \$141,000 respectively, of non-recurring custom services revenue. Recurring service revenue increased 3% from 2014 to 2015 due to an expanded customer base. The non-recurring custom services decreased 22% for custom services revenue due to the completion of a customer project in December 2014.

For the three months ended June 30, 2015, license and other revenue (comprised of third party hardware and royalties) increased 1566% from the corresponding period ending June 30, 2014. We realized an approximate \$1,854,000 increase in our core software license revenue, due to an order from a single customer. Third-party hardware sales increased by approximately \$43,000 (58%), as a result of an increase in existing OEM and customer deployments. Our royalty income was derived from an OEM agreement and remained the same revenue of \$20,584 for the three months ended June 30, 2015 and 2014.

### *Costs of goods sold*

For the three months ended June 30, 2015, cost of service decreased 50%, due to costs associated with a decrease in custom services. License and other costs for the three months ended June 30, 2015 increased approximately 84%. The increase is directly associated with the increase in third party hardware revenue.

### *Selling, general and administrative*

**Three months  
ended****June 30,**

|  | <b>2015</b> | <b>2014</b> | <b>\$<br/>Change</b> | <b>%<br/>Change</b> |
|--|-------------|-------------|----------------------|---------------------|
|--|-------------|-------------|----------------------|---------------------|

|  |           |           |          |     |
|--|-----------|-----------|----------|-----|
| <b>Selling, general and administrative</b> | \$979,861 | \$895,147 | \$84,714 | 9 % |
|--|-----------|-----------|----------|-----|

Selling, general and administrative costs for the three months ended June 30, 2015 increased 9% from the corresponding period in 2014. The increase is attributable to higher commissions, trade show attendance costs, travel expenses, channel marketing expenses, and factoring fees.

***Research, development and engineering*****Three months  
ended****June 30,**

|  | <b>2015</b> | <b>2014</b> | <b>\$<br/>Change</b> | <b>%<br/>Change</b> |
|--|-------------|-------------|----------------------|---------------------|
|--|-------------|-------------|----------------------|---------------------|

|  |           |           |            |       |
|--|-----------|-----------|------------|-------|
| <b>Research, development and engineering</b> | \$393,999 | \$470,888 | \$(76,889) | -16 % |
|--|-----------|-----------|------------|-------|

For the three months ended June 30, 2015, research, development and engineering costs decreased 16% due to reduced expenses related to temporary outside services for various projects.

*Other income and expense*

|                                   | Three months ended |          | \$         | %    |   |
|-----------------------------------|--------------------|----------|------------|------|---|
|                                   | 2015               | 2014     |            |      |   |
| <b>Interest income</b>            | \$2                | \$2      | \$-        | -    |   |
| <b>Gain (loss) on derivatives</b> | (406)              | 98,209   | (98,615)   | -100 | % |
| <b>Total</b>                      | \$(404)            | \$98,211 | \$(98,615) | -100 | % |

Interest income for the three months ended June 30, 2015 and June 30, 2014 consisted of bank interest.

During the fourth quarter of 2013, we issued various warrants that contained derivative liabilities. Such derivative liabilities are required to be marked-to-market each reporting period.

**SIX MONTHS ENDED JUNE 30, 2015 AS COMPARED TO JUNE 30, 2014****Consolidated Results of Operations - Percent Trend**

|                                 | Six Months Ended June 30, |       |  |  |
|---------------------------------|---------------------------|-------|--|--|
|                                 | 2015                      | 2014  |  |  |
| <b>Revenues</b>                 |                           |       |  |  |
| Services                        | 17 %                      | 30 %  |  |  |
| License fees and other          | 83 %                      | 70 %  |  |  |
| Total Revenues                  | 100 %                     | 100 % |  |  |
| <b>Costs and other expenses</b> |                           |       |  |  |
| Cost of services                | 4 %                       | 9 %   |  |  |
| Cost of license fees and other  | 6 %                       | 7 %   |  |  |

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|                          |      |      |
|--------------------------|------|------|
| Total Cost of Goods Sold | 10 % | 16 % |
| Gross profit             | 90 % | 84 % |

**Operating expenses**

|                                       |      |      |
|---------------------------------------|------|------|
| Selling, general and administrative   | 69 % | 99 % |
| Research, development and engineering | 27 % | 54 % |

|                          |      |       |
|--------------------------|------|-------|
| Total Operating Expenses | 96 % | 153 % |
|--------------------------|------|-------|

|                                |      |       |
|--------------------------------|------|-------|
| <b>Operating (loss) income</b> | -6 % | -69 % |
|--------------------------------|------|-------|

|                         |     |      |
|-------------------------|-----|------|
| Other income (expenses) | 0 % | -6 % |
|-------------------------|-----|------|

|                          |      |       |
|--------------------------|------|-------|
| <b>Net (loss) income</b> | -6 % | -75 % |
|--------------------------|------|-------|



**Revenues and cost of goods sold**

|                           | <b>Six months ended</b> |             |                  |          |               |
|---------------------------|-------------------------|-------------|------------------|----------|---------------|
|                           | <b>June 30,</b>         |             |                  |          |               |
|                           | <b>2015</b>             | <b>2014</b> | <b>\$ Change</b> | <b>%</b> | <b>Change</b> |
| <i>Revenues</i>           |                         |             |                  |          |               |
| Service                   | 505,622                 | 530,942     | (25,320 )        | -5       | %             |
| License & other           | 2,416,008               | 1,239,369   | 1,176,639        | 95       | %             |
| <i>Total Revenue</i>      | \$2,921,630             | \$1,770,311 | \$1,151,319      | 65       | %             |
| <i>Cost of Goods Sold</i> |                         |             |                  |          |               |
| Service                   | 123,968                 | 152,280     | (28,312 )        | -19      | %             |
| License & other           | 160,782                 | 126,195     | 34,587           | 27       | %             |
| <i>Total COGS</i>         | \$284,750               | \$278,475   | \$6,275          | 2        | %             |

***Revenues***

For the six months ended June 30, 2015 and 2014, service revenues included approximately \$277,000 and \$292,000, respectively, of recurring maintenance and support revenue, and approximately \$229,000 and \$238,000, respectively, of non-recurring custom services revenue. Recurring service revenue decreased 5% from 2014 as customers have been slow to renew existing maintenance agreements. The non-recurring custom services decreased 4% due to the completion of a customer project in December 2014.

For the six months ended June 30, 2015 and 2014, license and other revenue (comprised of third party hardware and royalties) increased as a result of several contributing factors. We realized an approximate \$1,121,000 increase (113%) in our core software license revenue primarily as a result of a single large order in 2015. Third-party hardware sales increased by approximately \$40,000 (19%), as a result of an increase in existing OEM and customer deployments. Our royalty income was primarily derived from an OEM agreement, however the 39% increase in revenue from \$41,168 to \$57,168 for the six months ended June 30, 2015 is from a single new customer. As a result we do not expect this upward trend to continue.

***Costs of goods sold***

For the six months ended June 30, 2015, cost of service decreased approximately \$28,000 from the corresponding period in 2014 due to decreased costs associated with non-recurring custom services revenue. License and other costs for the six months ended June 30, 2015 increased from the corresponding prior year period by approximately \$35,000. The increase is directly associated with the increase in third party hardware revenue.

*Selling, general and administrative*

|  | <b>Six months ended</b> |             |                      |                     |
|--|-------------------------|-------------|----------------------|---------------------|
|  | <b>June 30,</b>         |             |                      |                     |
|  | <b>2015</b>             | <b>2014</b> | <b>\$<br/>Change</b> | <b>%<br/>Change</b> |
| <b>Selling, general and administrative</b> | \$2,020,542             | \$1,752,143 | \$268,399            | 15 %                |

Selling, general and administrative costs for the six months ended June 30, 2015 increased 15% from the corresponding period in 2014. Increases included commissions and channel marketing expense due to increased revenue, personnel and recruiting costs, trade show attendance, travel, factoring fees and non-cash compensation.

*Research, development and engineering*

|  | Six months ended |           |             |          |
|--|------------------|-----------|-------------|----------|
|  | June 30,         |           |             |          |
|  | 2015             | 2014      | \$ Change   | % Change |
| <b>Research, development and engineering</b> | \$800,640        | \$957,545 | \$(156,905) | -16 %    |

For the six months ended June 30, 2015, research, development and engineering costs decreased 16% due to reduced expenses related to temporary outside services for a various projects.

*Other income and expense*

|                                   | Six months ended |             |           |          |
|-----------------------------------|------------------|-------------|-----------|----------|
|                                   | June 30,         |             |           |          |
|                                   | 2015             | 2014        | \$ Change | % Change |
| <b>Interest income (expenses)</b> | \$4              | \$3         | \$1       | 33 %     |
| <b>Income Tax</b>                 | (912 )           | (912 )      | -         | 0 %      |
| <b>Gain (loss) on derivatives</b> | 14,253           | (106,739)   | 120,992   | -113 %   |
| <b>Total</b>                      | \$13,345         | \$(107,648) | \$120,993 | -112 %   |

Interest income for the six months ended June 30, 2015 and June 30, 2014 consisted of bank interest.

During the fourth quarter of 2013, we issued various warrants that contained derivative liabilities. Such derivative liabilities are required to be marked-to-market each reporting period.

## **LIQUIDITY AND CAPITAL RESOURCES**

### **Cash Flows**

Net cash used for operations during the six months ended June 30, 2015 was approximately \$506,000. The cash used in operating activities was primarily attributable to the following items:

Net positive cash flows related to adjustments to depreciation, amortization, share-based compensation and fair value adjustments of approximately \$236,000.

Net negative cash flows related to movements in factored receivables, accounts receivable, inventory, prepaid expenses, accounts payable, and accrued expenses of approximately \$571,000 due to working capital management.

Net cash used for investing activities during the six months ended June 30, 2015 was approximately \$2,000 and related to capital expenditures.

Net cash used for financing activities during the six months ended June 30, 2015 was approximately \$54,000 and consisted of stock issuance costs.

Net working capital at June 30, 2015 was approximately \$509,000 as compared to net working capital of approximately \$485,000 at December 31, 2014.

## Capital Resources

Since our inception, our capital needs have been principally met through proceeds from the sale of equity and debt securities. We expect capital expenditures to be less than \$100,000 during the next twelve months. We do not currently maintain a line of credit or term loan with any commercial bank or other financial institution.

The following sets forth our primary sources of capital since January 1, 2013:

As of December 2011, we entered into a 24-month accounts receivable factoring arrangement with a financial institution (the "Factor"). Pursuant to the terms of this arrangement, from time to time, we sell to the Factor certain of our accounts receivable balances on a non-recourse basis for credit approved accounts. The Factor remits 35% for foreign and 75% for domestic of the accounts receivable balance to us (the "Advance Amount"), with the remaining balance, less fees payable by us, once the Factor collects the full accounts receivable balance from the customer. Factoring fees range from 2.75% to 15% of the face value of the invoice factored and are determined by the number of days required for collection of the invoice. In April 2012, the terms were updated from monthly to quarterly, and the 24-month arrangement was extended to August 1, 2014. In August of 2014, the 24-month arrangement was renewed. We expect to continue to use this factoring arrangement periodically to assist with our general working capital requirements due to contractual requirements.

On February 26, 2013, we issued a promissory note in the principal amount of \$497,307 (the "InterDigital Note") to DRNC. The InterDigital Note accrued interest at a rate of 7% per annum and was scheduled to mature on December 31, 2015. A portion of the proceeds from the sale of the InterDigital Note was used to repay the Colatosti Note in full, and the remaining proceeds were used for general corporate purposes. On November 22, 2013, we repaid in full the \$497,307 balance due under the InterDigital Note.

On February 26, 2013, we issued 2,013,468 shares of common stock to DRNC for an aggregate purchase price of \$402,693.

On February 26, 2013, we also issued 2,500,000 shares of common stock to a limited number of investors for an aggregate purchase price of \$500,000.

On July 23, 2013, we issued units to certain investors consisting of 1,750,003 shares of our common stock and warrants to purchase an additional 1,750,003 shares of our common stock at a purchase price \$0.60 per unit, for an aggregate purchase price of \$1,050,000. The warrants were originally exercisable at \$0.80 per share and expire five

years after the date of the grant. On December 2, 2013, we agreed to reduce the exercise price of the warrants to \$0.50 per share.

On October 25 and November 8, 2013, we issued an aggregate of 12,323,668 units consisting of 12,323,668 shares of common stock and warrants to purchase an additional 12,323,668 shares of common stock at a purchase price \$0.30 per unit for an aggregate purchase price of \$3,697,100 prior to a deduction for placement agent fees and expenses. The warrants are exercisable at \$0.50 per share and expire three years after the date of the grant.

In November 2014, we issued an aggregate of 7,974,999 shares of our common stock and warrants to purchase an additional 11,962,501 shares of common stock for an aggregate purchase price of \$1,595,000. The warrants have a term of five years and an exercise price of \$0.30 per share.

### *Liquidity outlook*

At June 30, 2015, our total cash and cash equivalents were approximately \$282,000, as compared to approximately \$844,000 at December 31, 2014.

As discussed above, we have historically financed our operations through access to the capital markets by issuing secured and convertible debt securities, convertible preferred stock, common stock, and recently through factoring receivables. We estimate that we currently require approximately \$460,000 per month to conduct our operations, a monthly amount that we have been unable to consistently achieve through revenue generation. During the first six months of 2015, we generated approximately \$2,922,000 of revenue, which is above our average monthly requirements. Excluding share based compensation, we met our monthly operation requirements through June 30, 2015.

If we are unable to continue to generate sufficient revenue to meet our goals, we will need to obtain additional third-party financing to (i) conduct the sales, marketing and technical support necessary to execute our plan to substantially grow operations, increase revenue and serve a significant customer base; and (ii) provide working capital. We may, therefore, need to obtain additional financing through the issuance of debt or equity securities.

Due to several factors, including our history of losses and limited revenue, our independent auditors have included an explanatory paragraph in their opinion related to our annual financial statements as to the substantial doubt about our ability to continue as a going concern. Our long-term viability and growth will depend upon the successful commercialization of our technologies and our ability to obtain adequate financing. To the extent that we require such additional financing, no assurance can be given that any form of additional financing will be available on terms acceptable to us, that adequate financing will be obtained to meet our needs, or that such financing would not be dilutive to existing stockholders. If available financing is insufficient or unavailable or we fail to continue to generate sufficient revenue, we may be required to further reduce operating expenses, delay the expansion of operations, be unable to pursue merger or acquisition candidates, or continue as a going concern.

#### **ITEM 4. CONTROLS AND PROCEDURES**

##### *Disclosure Controls and Procedures*

Our management, with the participation of our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2015. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of June 30, 2015, our CEO and CFO concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

##### *Changes in Internal Control Over Financial Reporting*

No change in our internal control over financial reporting occurred during the fiscal quarter ended June 30, 2015, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.



## **PART II — OTHER INFORMATION**

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

1. During the first quarter of 2015, we issued options to purchase an aggregate of 75,000 shares of common stock to two new employees. The options are exercisable at \$0.20 per share, have a term of seven years and vest in equal installments over a three-year period commencing on the date of grant.

2. During the first quarter of 2015, we issued a warrant to purchase 575,000 shares of common stock to a consultant in consideration of services. The warrant is exercisable at \$0.21 per share, has a term of five years and vests in equal quarterly installments over a one-year period commencing on the date of grant.

The foregoing securities were issued in a private placement transaction pursuant to the exemption from registration provided by Section 4(2) of the Securities Act of 1933, as amended, without general solicitation or advertising of any kind and without payment of brokerage commissions to any person.

### **ITEM 6. EXHIBITS**

The exhibits listed in the Exhibits Index immediately preceding such exhibits are filed as part of this Report.

## SIGNATURES

In accordance with the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

### **BIO-Key International, Inc.**

Dated: August 14, 2015 /s/ Michael W. DePasquale  
Michael W. DePasquale  
Chief Executive Officer

Dated: August 14, 2015 /s/ Cecilia C. Welch  
Cecilia C. Welch  
Chief Financial Officer

**EXHIBIT INDEX**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 31.1               | Certificate of CEO of Registrant required under Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended |
| 31.2               | Certificate of CFO of Registrant required under Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended |
| 32.1               | Certificate of CEO of Registrant required under 18 U.S.C. Section 1350   |
| 32.2               | Certificate of CFO of Registrant required under 18 U.S.C. Section 1350   |
| 101.INS            | XBRL Instance  |
| 101.SCH            | XBRL Taxonomy Extension Schema   |
| 101.CAL            | XBRL Taxonomy Extension Calculation  |
| 101.DEF            | XBRL Taxonomy Extension Definition   |
| 101.LAB            | XBRL Taxonomy Extension Labels   |
| 101.PRE            | XBRL Taxonomy Extension Presentation   |